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The Mighty Dollar – Is it still so mighty?

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When people talk about the mighty dollar, they are not normally talking about USD strength. The value of the USD is best looked at via the Dollar Index. The DXY value is decided by normal currency drivers such as trade and investment flows and affected by confidence in the USA's economic and political outlook. The USD is historically a safe haven currency and COVID initially drove up the value, but since then it has been weakening as concerns over trade and domestic issues have come into play.

For most the mighty refers to the importance the USD has in international trade and payment settlement and systems, and the influence access to the USD has on geopolitical dynamics. The USD is still without doubt the preeminent global currency. After WW2 countries' currencies were fixed against the USD with the Bretton Woods system, which also linked USD to Gold. In the 70s the demand for Gold grew due to inflation concerns, so America removed the tie to gold to protect its gold holdings, and USD naturally became the world's reserve currency. Most global trade contracts are transacted in USD and the majority of FX settlements are also in USD. The main International payment systems like SWIFT also focus mainly on USD. Because of the dominance of the USD, over the years many countries have also pegged their currencies to the USD to give stability to their economies and assist in their international trade to drive growth, which would lag if they continued with their own free domestic currency. In addition, many countries hold in their reserves large amounts of USD assets like Treasuries.

All of this has given America huge influence in geopolitical issues and in trade negotiations, such as in sanctions blocking access to the USD for trade settlement for NK and Iran. Established systems which focus on USD (SWIFT) have only empowered the US further.

Access to dollars has become increasingly important, and some nations have been economically damaged from a USD squeeze because of a specific lack of access. So, the granting of USD swap lines by the USA to select friendly nations is a very powerful ability to allocate – or not – and can mean economic life or death if there were a dollar squeeze.

This has raised concerns amongst some nations, especially those who are at odds with the US traditionally, such as Russia and China. A move towards de-dollarization has started, as evidenced by Russia and China who are partnering to reduce their dependence on the dollar, a development some experts say could lead to a "financial alliance" between them. A move away from reliance on dollars has been developing for awhile, but some think the Covid-19 pandemic has accelerated the process due to the ballooning of US credit, US economic reliance on consumption and because of recent political moves by Trump against certain nations. This is causing concern

and driving a move away from treasuries towards gold and other assets, and has contributed to recent weakness in the dollar this year.

China and Russia are setting up their own payment systems not using dollars. Another development has been Chinese investment abroad in commodities (60% of imports for China are for raw commodities) and a push to increase the use of Yuan internationally, which reduces their need for USD going forward. But despite China's Belt and Road initiative investing huge sums of money into other economies, its share of Belt and Road trade denominated in RMB is just 14%.

In the first quarter of 2020, use of dollars in trade between Russia and China fell below 50% for the first time on record (46%). At the same time EUR made up an all-time high of 30%, while their national currencies accounted for 24%, also a new high. As recently as 2015, approximately 90% of bilateral transactions were conducted in dollars. The figure had dropped to 51% by 2019.

Other small countries, who under current American foreign policy are less likely to be the benefactors of American graces, also have an interest to move away from using the dollar. Some accept loans from China and sell commodities back to China in offshore Yuan. This can mean they end up short of USD and are susceptible to USD squeezes as a result as they adjust financial flows. As such, there could be a period of difficulty as the world transitions away from such dollar dependence.

The worlds almost total reliance on the USD for international trade and as a global reserve currency has had advantages and disadvantages. In the past it added stability and made international trade easier, but the dominance of the USD and its 'use' has raised concerns. A global reserve and settlement currency that was neutral and not controlled by one currency would be ideal, but none is currently developing.

America's foreign policy under Trump is one of the main accelerators of this trend, and regardless of any change in US leadership come November, a move to a wider spread of different currencies seems to be the likely outcome. Add in FINTECH development easing this trend and it seems likely that the peak of the mighty dollar as the one and only global reserve and settlement currency is in our rear view mirror, and will have an interesting effect on global stability.

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